

# Reconfiguring Social Security for the 21st Century

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# Reconfiguring Social Security for the 21st Century

*It is well accepted that the Social Security system will need reform when the baby boomers begin to retire—but how best to change this most successful program? This article looks at several models for reforming Social Security for the next century.*

**By Susan A. Channick**

**T**he Old-Age, Survivors' and Disability Insurance program (OASDI)<sup>1</sup> of the Social Security system is a mandatory social insurance program with a dual purpose: to replace income lost to eligible workers due to retirement and to provide a safety net against impoverishment for the most vulnerable of these retired workers. These two goals are often described as individual equity—i.e., ensuring that participants get a fair rate of return on their lifetime contributions to the system—and social adequacy or progressivity—i.e., ensuring every person's access to certain basic services through redistribution of contributions.<sup>2</sup>

Social Security, by all accounts, has been a tremendous success. It provides benefits to 44 mil-

lion Americans who are elderly, disabled, and survivors of deceased workers. Without Social Security, half the elderly would live in poverty.<sup>3</sup> The program has been immensely popular, particularly among the elderly—so popular, in fact, that politicians identify it as the third rail of American politics: "Touch it and you die."<sup>4</sup> Because of the nature of funding the system, current recipients of Social Security benefits have enjoyed unusually high rates of return on their "investment."<sup>5</sup> This perception has perpetuated a sense in this generational cohort that Social Security is an inviolate entitlement. This position, in turn, has helped to create the stereotype of the aged as greedy, politically powerful, and selfish and has fueled an inevitable intergenerational conflict for limited resources.<sup>6</sup>

## **The Pay-as-You-Go Model**

The cash benefits paid to eligible retirees<sup>7</sup> are funded from current payroll taxes,<sup>8</sup> not from a prefunded so-called Social Security trust fund.<sup>9</sup> The pay-as-you-go (PAYG) model<sup>10</sup> that has characterized the program since its inception in 1935<sup>11</sup> depends for its survival on a payroll tax base that does not fall below the value of benefits promised to eligible retirees and their derivative beneficiaries.<sup>12</sup> As long as contributions from current workers subject to payroll taxes exceed or at least equal unfunded benefits promised to eligible retirees,<sup>13</sup> the tax-benefits relationship creates an upright pyramid that is the hallmark of the PAYG model.

Currently, the PAYG system is operating at a surplus;<sup>14</sup> the excess taxes over benefits accumulation make up a small "trust fund" that is invested in federal government bonds. These bonds create obligations in the federal government to the OASDI program that will be used to satisfy future benefit payments to eligible retirees. Since the

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bonds represent a past accumulation of payroll taxes, they can properly be considered a prefunded Social Security trust fund that will, to some extent, offset future PAYG benefits needs. In addition, while the Federal Insurance Contributions Act (FICA) payroll tax-benefits relationship yields a surplus, the temporary effect of this surplus is a reduction in the federal deficit.<sup>15</sup>

For a number of well-identified reasons, the current PAYG model is projected to fail around 2012 when the payroll tax revenues from the current workforce will no longer exceed benefits obligations to eligible retirees. At that time, the system will be operating at a deficit, and the federal government will be required to raise additional revenue in order to fund the trust fund.<sup>16</sup> It is this projected reversal of the tax-benefits pyramid that concerns economists, politicians, and those eligible workers relying on Social Security benefits to at least partially fund their retirement. At that time, the current PAYG model will no longer be able to provide benefits previously promised to eligible retirees without a concomitant increase in taxes, reduction and/or delay in benefits, or other major overhaul of the system.

A cogent question is why a model that has been fundamentally successful for 65 years will not be able to sustain its success at meeting the retirement needs of aging Americans into the 21st century. The primary reason is attributed to what is popularly known as the baby boom generation. Identified as those persons born between 1946 and 1964, this generation represents an aberrant population cohort relative to the prior and subsequent U.S. fertility rate, which had stabilized around 1920 at 2.1 and has since dropped significantly. The current PAYG Social Security model is an upright pyramid that relies on payroll taxes in excess of benefits to work. The baby boomers represent a bulge in the U.S. population on both ends of the curve; the critical factor is that this generation has not restabilized the previous U.S. fertility rate of 2.1 and indeed has not even replaced itself. When the first of the baby boomers retire at age 62 in 2012, the Social Security pyramid will necessarily invert because benefits will exceed contributions.<sup>17</sup> According to projections, in 2030, when all of the boomers have reached age 65, Social Security will be running an *annual* cash deficit of \$766 billion.<sup>18</sup>

In addition to the sheer numbers of the baby boom generation, another factor is the increased life expectancy of American adults since 1935. First, more workers are surviving to retirement. In 1940, only 53.9 percent of eligible men reached retirement age, compared with 72.3 percent in 1990; for women the figure rose from 60.6 percent to 83.6 percent.<sup>19</sup> Second, once reaching retirement, workers are living longer, thereby increasing their burden on the system. For example, the average life expectancy of men following retirement rose from 12.7 to 15.3 years between 1940 and 1990, while the average life expectancy of women during the same period rose from 14.7 to 19.6 years.<sup>20</sup>

### Early Retirement

Yet another force putting a strain on the current PAYG model is the increase in the retired population due to earlier retirement. In 1950, the average age for first receipt of Social Security benefits was 68.7 for men and 68.0 for women; in 1991, the average first benefits receipt ages were 63.7 and 63.5, respectively.<sup>21</sup> These statistics seem to demonstrate that Americans are retiring earlier. By taking itself out of the workforce, this new retired cohort puts a dual strain on the system both by reducing the overall contributions of the current working population and by increasing the demand on the benefits side of the PAYG equation.

There is much literature to support the argument that the structure of the current Social Security system discourages the elderly from working beyond age 62, the age at which workers are first eligible to receive benefits.<sup>22</sup> A worker who elects to retire and receive benefits prior to age 65 is entitled to receive benefits that are permanently decreased as a result of electing early retirement.<sup>23</sup> While the policy of permanently decreased benefits should have the effect of persuading potential beneficiaries to continue to work until age 65, in fact many eligible persons do retire early in the belief that the increase in benefits from continuing to work may not adequately compensate them for a year of forgone benefits.<sup>24</sup> Since the reduction is arrived at actuarially, there should be no direct benefit to early retirement; however, the indirect effects of early retirement can more than offset the reduction.<sup>25</sup>

In addition to the actual net effect of early retirement on income is the well-accepted percep-

tion that early retirement has a positive net effect on return.<sup>26</sup> Because people regularly assume for themselves a shorter rather than a longer life expectancy, the perception is that retiring early is economically preferable to waiting until normal retirement age.<sup>27</sup> This perception acts as a disincentive for people to continue working, thus accelerating the inversion of the tax-benefits pyramid.

Even those workers who elect normal retirement age over early retirement have further disincentives to work past age 65. First, the Social Security benefit formula is designed to achieve a balance between the program's twin goals: old-age insurance and social welfare.<sup>28</sup> To achieve both goals, the benefit formula reduces the payroll tax-benefits rate of return for certain workers in order to augment the benefits of other workers.<sup>29</sup> In order to accomplish this redistributive function, Social Security has always operated on a defined benefit model.<sup>30</sup> Since a worker's earnings are not segregated into private accounts payable only to that worker, contributions in excess of the amount necessary to comprise the highest possible benefit for that worker are, at least personally, unproductive.

The primary insurance amount (PIA) is the amount that a worker is entitled to upon retiring at normal retirement age. Although the PIA is related to a worker's contributions, the social welfare or adequacy value of the system dictates that the relationship be less than complete. In order to accomplish its redistributive effect, the PIA is formulated to provide a less than 100 percent rate of return on a worker's contributions. For example, for a single worker who turned 62 in 1996, the rate of return on the first \$10,000 of taxable wages was 62 percent, while the rate of return on taxable wages in excess of \$60,000 was 29 percent.<sup>31</sup> For high-earning workers, the Social Security system provides little incentive to continue to work beyond normal retirement age, both because FICA only taxes the first \$68,400 (in 1998) of income and because the rate of return on taxed income decreases significantly as the amount of taxed income increases.

The system does provide a "delayed retirement credit" incentive for persons who defer receipt of their benefits after normal retirement age. For each year of deferral until age 70, the recipient can increase his or her benefit by a stated percentage authorized by the statute.<sup>32</sup> Presently, the delayed retirement credit of 5 percent is not actuarially fair and therefore does not compensate a worker for a

year of forgone benefits.<sup>33</sup> In addition, workers who elect this option remain subject to both payroll and income taxes, which may completely offset the economic incentive to forgo retirement benefits.

Second, the formula for computing a worker's benefit is based on the worker's highest 35 years of wage-indexed earnings.<sup>34</sup> Unless a worker's post-65 earnings subject to FICA are substantially higher than his or her prior years' earnings or the worker has not worked 35 qualifying years at the time the benefit computation is made, there is no concomitant increase in benefit for working more than 35 years prior to retirement.

Third, persons are penalized in a number of ways when they continue to perform compensated work while receiving retirement benefits. Social Security imposes a "retirement earnings" test that limits the amount of earnings a retiree can have before benefits are reduced.<sup>35</sup> It is important to note that the retirement earnings test looks exclusively to income derived from performing personal services. Strangely, it does not include income from other sources such as interest, dividends, rents, annuities, pension plan distributions, or capital gains.

Additionally, all persons, regardless of age, whose employment is covered by Social Security are subject, either directly or indirectly, to current Social Security and Medicare payroll taxes of 12.4 percent and 2.9 percent, respectively. So persons eligible for Social Security benefits free of payroll taxes who instead elect to continue working also continue to be subject to this 15.3 percent tax on earnings. Ironically, persons who elect to receive retirement benefits but whose income exceeds the applicable excess earnings thresholds are subject to payroll taxes on the excess earnings. The double penalty of a \$1 to \$2 or a \$1 to \$3 reduction in Social Security benefits, coupled with a payroll tax on the excess earnings, may act as a disincentive to continued employment to all but high-earning eligible beneficiaries.

## **Proposals for Reform**

### ***A New Model for the 21st Century***

Given these facts, it seems quite clear that in order for the system to continue into the 21st century, reform is necessary. The dominant policy response of the 20th century has been to raise the payroll tax in order to continue to support the unfunded pay-

roll tax-benefits model. Beginning in 1937, the combined payroll tax for employers and employees was 2 percent on wages up to \$3,000, which rose to 3 percent on wages up to \$3,500 by 1951. By 1997, the combined tax was 10.52 percent on wages up to \$65,400 for old-age insurance. In 1956, Congress added a disability program to Social Security with its own payroll tax. By 1998, the combined payroll tax for old-age insurance and disability was 12.4 percent on wages up to \$68,400. In addition, Medicare, enacted in 1965, has its own payroll tax of 2.9 percent of all wages.<sup>36</sup> As late in the century as 1983, President Ronald Reagan and Congress “rescued” Social Security with a bipartisan \$168 billion package in which an increase in the payroll tax played a central role.<sup>37</sup>

Certainly, one way in which Social Security can be again rescued for future generations of beneficiaries is to continue the current policy into the 21st century. There are those who believe that an approximately 2 percent increase in the payroll tax would take care of the problem for the next 75 years. This solution, while it could temporarily close the projected payroll tax-benefits shortfall and postpone a budget deficit, does not change the current PAYG model. And if PAYG is destined to continuously fall short as long as the payroll tax-benefits pyramid remains inverted, merely raising the payroll tax is not enough.

There are a number of other problems with this solution. First, it increases an already regressive tax, the direct effect of which is likely to be disproportionately harsh on low-earning workers. Second, the increase again is just a stopgap measure. As Michael Boskin has noted, the modest adjustments made in 1983 were calculated to create a solvent system for 75 years. He predicts that to put Social Security in actuarial balance requires an immediate 5 percent tax increase, more if the increase is delayed.<sup>38</sup> Third, a tax increase would be politically difficult to achieve in a time when the general public is convinced that Social Security is flush with surplus.

Fourth, raising the payroll tax (or decreasing benefits) has the effect of lowering workers’ rates of return from the system. This consideration is one of both economics and politics. The PAYG approach of the past century depends for its success on contributions exceeding benefits. It has worked because, although the payroll tax was relatively low while the return on investment was relatively

high, it was a politically popular and supportable model. However, as the tax has increased and the rate of return decreased, this model is likely to lose some of its popularity and its political constituency.<sup>39</sup> Last, raising payroll taxes only maintains the status quo—an unfunded PAYG defined benefit system—without any real change in the existent system. While there is always some appeal to stasis, this remedy has been tried often enough in the past so that its effectiveness has been well tested and documented.

Although there seems to be some consensus that continuing with the reform policy of the 20th century is inapt,<sup>40</sup> there is little consensus as to what reform is apt for the new millennium.<sup>41</sup> There certainly are strong constituencies on both ends of the reform continuum, from those advocating more modest reforms to those suggesting wholesale changes to the existing system.<sup>42</sup> Those who support retooling the current system rather than replacing it are motivated at least to some degree by the importance of the social protection value of the current system, which has relied on redistribution of contributions into benefits. This constituency advocates such changes as reducing benefits, increasing the payroll tax base, adding progressivity to the system by taxing Social Security benefits like other retirement benefits, and otherwise creating incentives for workers, particularly high earners, to continue working instead of electing retirement at normal retirement age.

### ***The Prefunded Model***

A less modest but not overly controversial reform advocated by a number of constituencies involves changing Social Security from the traditional PAYG model to a prefunded model. This suggestion takes many forms, but the underlying rationale is the same. While a PAYG model had much value particularly during the early- to mid-20th century, in order to create a popular and immediate income replacement and insurance program at a time when contributions to the system consistently exceeded benefits to retirees, the good reasons for an institutionalized shift of assets from workers to their aged parents may no longer be so compelling.<sup>43</sup> First, poverty among the elderly has been significantly reduced.<sup>44</sup> In addition, the elderly cohort is economically varied; no one set of adjectives describes the entire population. Second, there is some evidence that at least some of the baby boom genera-

tion, responding to a shaken public confidence in the ability of the Social Security system to fund its retirement, has saved privately through such vehicles as private pension plans and IRAs.<sup>45</sup> If this is true, the need to have a younger generation disproportionately burdened to support it is diminished.

Various reform proposals include prefunding. One possible approach, modeled on the existing system, would prefund a single government-managed defined benefit trust fund by raising the payroll tax a small amount and allowing the trust fund to invest the increase in common stock funds rather than restricting the contribution investment to government bonds.<sup>46</sup> This mandatory payroll tax increase would create forced savings<sup>47</sup> and make benefits more affordable in the long run. If equities continue, as they have, to outperform the bond market, the long-term solvency of the trust fund could be restored.<sup>48</sup>

Under the PAYG model, payroll taxes collected from current workers are paid out immediately in benefits to eligible retirees; the only real investment in government obligations is the surplus of tax in excess of benefit.<sup>49</sup> The rate of return in a PAYG system is what Martin Feldstein calls the "implicit" rate of return, because there is no real investment.<sup>50</sup> Currently, the implicit rate of return has been calculated at 2 percent per year due to both the greater number of workers and their higher wages, which, while not high, will offset the cost of benefits to future generations.<sup>51</sup>

The value of a prefunded model is a real rate of return on the investment of that amount of payroll contributions that equals forced savings.<sup>52</sup> The higher real rate of return reduces the payroll tax contribution burden of younger generations for the benefit of older generations. The sooner in time a "savings" component of payroll tax is adopted, the greater the generational equity because the working population will, at least to some extent, be saving for its own retirement.<sup>53</sup> On the other hand, generational inequity is at its highest in a pure PAYG system where the payroll tax-benefits pyramid has inverted.

The more recent addition to the prefunding dialogue is the current debate concerning how to allocate the approximately \$1 trillion budget surplus projected to occur over the next 15 years.<sup>54</sup> In his January 19, 1999, State of the Union speech, President Clinton proposed committing 60 percent of the surplus for the next 15 years to Social

Security,<sup>55</sup> a suggestion with which, in principle at least, Federal Reserve Board Chairman Alan Greenspan is in agreement.<sup>56</sup> In addition, many policymakers and legislators on both sides of the political and economic debate agree, again at least in principle, with the concept of allocating some of the surplus to prefund Social Security's future obligations.<sup>57</sup> The point of real departure is whether wholesale changes need to be made to the fundamental structure of the system.

### ***The Privatization Model***

Whereas President Clinton's USA, or universal savings account, plan is based on stimulating private savings to pay for what have heretofore been public entitlements,<sup>58</sup> proposals for privatizing the entire system are much more revolutionary.<sup>59</sup> These more controversial reform proposals dictate moving from the current defined benefit model to a defined contribution model so that the return on investment more closely approximates many private pension plans, the so-called privatization model. However, the correlative effect of such a paradigm shift could threaten the value of social protection that has been so successful in reducing poverty and insecurity among the elderly.<sup>60</sup> The hallmark of the defined contribution model is that a worker's rate of return or benefit from the system equals his or her lifetime contributions plus growth. Integral to defined contribution proposals is the privatization portion, i.e., the worker's right to self-direct his or her own investments with an ability to invest in private debt and equity instruments.

There are a number of so-called privatization proposals floating around; all share the concept of earmarking at least some percentage of a current worker's payroll tax to go to individual accounts to be used for income replacement at retirement.<sup>61</sup> Privatizing would certainly improve the rate of return for individuals, particularly high-earning workers, by the use of a defined contribution model invested in private debt and equity instruments. Workers who start contributing early enough in their working lifetimes can take advantage of real rates of return on investments. Where, however, does this leave those workers whose benefits have already accrued under the existing defined benefit PAYG model? And, indeed, where does this leave low-earning workers whose opportunity for a decent retirement was heretofore guar-

anteed by the redistributive effect of the existing social insurance model?

While privatization might create some benefits, it is not without its problems. First, substituting a defined contribution privatized model for the current system is not the solution for the shortfall created by already accrued Social Security liabilities. Although this shortfall may be covered while the surplus of contributions over benefits lasts, it seems neither prudent or wise to assume a permanent surplus.<sup>62</sup> And once a budget surplus can no longer be relied on to cover already accrued benefit liabilities, the system becomes PAYG with respect to those liabilities. Second, many privatization proposals advocate using the budget surplus to prefund individual accounts, leaving already accrued liabilities to continue to be funded on a PAYG basis either from an increase in payroll taxes or from an allocation of general revenues.

Third, while privatization can reward the informed and fortunate investor, it creates market risks that many workers can ill afford and may indeed be unprepared to take. To the extent that high-earning workers might be more willing and able to tolerate risk than low-earning workers, the fairness or progressivity value of Social Security has been eroded. One way to maintain fairness and progressivity while increasing the rate of return is to privatize the public trust fund, i.e., to allow OASDI trust funds to invest some portion of payroll tax in private equity and debt instruments instead of government bonds. The problems inherent in that approach have been pointed out by numerous politicians and economists, most notably Alan Greenspan,<sup>63</sup> although other entitlements experts have made suggestions regarding methods designed to insulate from abuse the investment of such a huge public fund in private instruments.<sup>64</sup>

Last but perhaps not least, privatization in the form of a defined contribution model dramatically reconceives Social Security as a national retirement income security system that guarantees both equity and adequacy. Social Security is neither a private pension plan nor a welfare program. It is intended instead to provide a floor of protection to which can be added private-sector income replacement plans. As such, Social Security cannot sacrifice the provision of socially adequate benefits for equitable benefits; both values must be protected.<sup>65</sup> These twin goals have been well served by a defined benefit system that both redistributes con-

tributions and incorporates progressivity. It may be that a defined contribution with a minimum benefit guarantee model would equally well or better serve the twin goals of income adequacy and income equity, but replacing the old model with a completely new one seems premature. There is much room within the current system for comprehensive, multilateral retooling to meet the changing needs of the 21st century. While there is certainly consensus that the current system needs reform, it is anything but clear that this reform should be revolutionary. Now is the time to throw out the old bathwater but keep the baby.

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### Endnotes

1. 42 U.S.C. §§ 401 *et seq.*
2. See C. Eugene Steuerle & Jon M. Bakija, *Retooling Social Security for the 21st Century*, 2 SOC. SECURITY BULL. 37 (1997).
3. Henry J. Aaron & Robert D. Reischauer, *The Future of Social Security: Tune It Up, Don't Trade It In*, 1/1/99 WASH. Q.
4. The third-rail analogy comes from the Metro System of Washington, D.C., where the power to the system comes from the third rail.
5. As explained below, Social Security is an unfunded program, so those benefit recipients who did not contribute to the system their entire working lives but receive full benefits have enjoyed a greater rate of return than those future beneficiaries who have contributed to the system their entire working lives. Edward M. Gramlich, *IS IT TIME TO REFORM SOCIAL SECURITY?* 34-39 (1998).
6. Robert H. Binstock, *Public Policies on Aging in the Twenty-First Century*, 9 STAN. L. & POL'Y REV. 311, 312-13 (1998).
7. For example, in 1996 the OASDI program paid more than \$300 billion in benefits to almost 38 million Americans. Jonathan Barry Forman, *Reforming Social Security to Encourage the Elderly to Work*, 9 STAN. L. & POL'Y REV. 289 (1998).
8. In 1998, the first \$68,400 of a worker's earnings were subject to a 12.4 percent tax levied by the Federal Insurance Contributions Act (FICA), which is part of the Internal Revenue Code.

9. See generally Richard L. Kaplan, *Top Ten Myths of Social Security*, 3 ELDER L. J. 191 (1995).
10. For political reasons—because payroll taxes far in excess of benefits would have been required—it has never been possible to fund a sizable reserve. The system has always used present-day payroll taxes from the current workforce to pay the benefits of retirees who had previously paid payroll taxes. Gramlich, *supra* note 5, at 11.
11. Prior to Congress's enactment of Social Security in 1935, President Franklin D. Roosevelt argued for a program that was largely prefunded, but this was ultimately rejected and the program has evolved on a PAYG model. Roosevelt's contributory prefunded proposal was opposed by the political left, who felt the program should be a noncontributory universal assistance one, and on the political right by those who believed the program should be funded and made available by purely voluntary contributions. *Id.*
12. Under the current system, OASDI pays benefits not only to retired workers but also to certain eligible spouses, divorced spouses, children, and parents of retired workers. The payment of derivative benefits to a beneficiary's spouse and other family members while the beneficiary is still alive and collecting benefits himself or herself is one way in which this retirement system is different from private pension plans that provide only survivor benefits.
13. The total unfunded current liability of Social Security promises is said to be, in round numbers, \$10 trillion, twice the national debt. Michael J. Boskin, *A Framework for Considering Social Security Reform*, in FRAMING THE SOCIAL SECURITY DEBATE 29, 37 (R. Douglas Arnold, Michael J. Graetz, & Alicia H. Munnell, eds., National Academy of Social Insurance 1998) (hereinafter SOCIAL SECURITY DEBATE).
14. One of the recognized reasons that the OASDI program is currently operating at a surplus is because of a raise in payroll taxes in the mid-1980s on the recommendation of a blue-ribbon bipartisan commission on Social Security reform chaired by Alan Greenspan.
15. Whether this temporary reduction in the federal deficit is a benefit or a burden is debatable. Whereas reducing the deficit can have the positive effect of reducing interest rates and encouraging private investment, it has been argued that in the absence of the use of the trust fund surplus to reduce the deficit, Congress would be more inclined to find other, more direct ways of reducing the deficit. See Steuerle & Bakija, *supra* note 2, at 41.
16. According to the Social Security Trust Fund Trustees' 1998 Report, from 2013–2021, 100 percent of benefits can be paid from tax receipts plus interest on trust fund assets. After 2021, total income will fall short of benefits but can be funded in full from tax receipts and drawing down trust fund assets until the trust fund is exhausted in 2032. Alicia H. Munnell, *Introduction*, in SOCIAL SECURITY DEBATE, *supra* note 13, at 3.
17. In 1950, there were 16 workers to pay the benefits of each retiree; in 1960, there were 5 workers per beneficiary. By 2008, the number of workers per beneficiary is projected to be 3, and by 2030, that number is projected to be 2. "Workers in 2030 are projected to have to pay two and a half times as much as 1960 workers to provide retirement benefits." See Gramlich, *supra* note 5, at 28.
18. Peter G. Peterson, WILL AMERICA GROW UP BEFORE IT GROWS OLD? 31 (1996).
19. See Steuerle & Bakija, *supra* note 2, at 40.
20. *Id.*
21. *Id.*
22. See generally Forman, *supra* note 7; Steuerle & Bakija, *supra* note 2.
23. A worker retiring at age 62 sustains a permanent reduction in his or her lifetime Social Security benefit equal to 80 percent of the benefit he or she would be entitled to had he or she retired instead at age 65. This reduction is actuarially calculated so that there is no benefit to be gained from early retirement.
24. The Advisory Council on Social Security reports that more than half of new Social Security beneficiaries claim their benefits at age 62, and 72 percent of new beneficiaries claim their benefits before age 65. See Advisory Council on Social Security, Report of the Technical Panel on Trends and Issues in Retirement Savings, in 2 REPORT OF THE 1994–1996 ADVISORY COUNCIL ON SOCIAL SECURITY I, 21 (1997).
25. But that does not tell the whole story. Although the actual lifetime benefit is reduced by electing retire-



- ment at age 62, the savings in payroll tax payments more than offsets the reduction. In addition, the added taxes paid from ages 62 to 65 do not increase the worker's retirement benefit at age 65. Steuerle & Bakija, *supra* note 2, at 51.
26. *Id.* at 52.
  27. While normal retirement age (NRA) has always been 65, the 1983 Social Security Amendments scheduled a gradual increase in the NRA from 65 to 67 in 2025. There are several proposals to further increase the NRA to 70 by 2029. Peter M. Wheeler & John R. Kearney, *Income Protection for the Aged in the 21st Century: A Framework to Help Inform the Debate*, 2 SOC. SECURITY BULL. 3 (1996).
  28. Edward Gramlich identifies these twin values as "social adequacy—giving low-wage workers a livable benefit level in their retirement—and individual equity—providing a decent return on the contributions of all workers, including high-wage workers." Gramlich, *supra* note 5, at 13.
  29. Not only does this redistribution transfer benefits from higher-earning to low-earning beneficiaries, it also redistributes benefits from men to women, from single people to married couples, and from two-earner couples and singles to single-earner couples. The first is true because women have longer life expectancies and will be entitled to benefits for more years than men. The second and third are true because of Social Security's policy of derivative beneficiaries, i.e., those beneficiaries who are entitled to retirement benefits as an indirect consequence of their relationship with those workers who are entitled to benefits directly because of their contributions to the system. Laurence J. Kotlikoff, *PRO: Privatizing Social Security*, 3 BROOKINGS REV. 16 (1997).
  30. Social Security is a defined benefit pension plan because a worker's benefits are determined by formulas that relate benefits to the worker's past earnings. In contrast, a defined contribution pension plan is one in which the worker's benefits are determined by the actual accumulation of past contributions.
  31. Gramlich, *supra* note 5, at 14.
  32. 42 U.S.C. § 402(w). For example, a worker born in 1932 whose NRA benefit plus intervening cost-of-living adjustments (COLAs) is \$800 per month and who chooses to delay retirement until age 68 is entitled to three years of "delayed retirement credit." At 5 percent per year, this worker's recomputed monthly benefit would be \$920, which he or she would receive beginning at age 68 and to which all future COLAs would be applied. Lawrence A. Frolik & Richard L. Kaplan, *ELDER LAW* 281–82 (West 2d ed.).
  33. Forman, *supra* note 7, at 292.
  34. Wage indexing means that wages on which workers have paid payroll taxes are brought up to date and computed as if they were earned the year the worker turned 60. In other words, the wages are inflated at the rate of growth of taxable wages in the economy. Wage indexing should be contrasted with price indexing, the formula by which an eligible worker's benefit is inflated at the rate of increase of the consumer price index.
  35. The amount that a Social Security recipient can earn without being taxed depends on the recipient's age. In 1998, persons younger than 65 could earn \$9,120, and persons age 65 to 70 could earn \$14,500 without triggering a loss in benefits. Once the thresholds are exceeded, benefits are reduced \$1 for each \$2 of excess earnings for persons below full retirement age and \$1 per \$3 of excess earnings for persons who have reached full retirement age. Persons age 70 and older are not affected by this so-called excess earnings tax.
  36. Gramlich, *supra* note 5, at 12.
  37. See Paul C. Light, *The Way We Were? Beware the Tricks That Social Security Memories Play*, 2 BROOKINGS REV. 47 (1998).
  38. Michael J. Boskin, *supra* note 13, at 33.
  39. Martin Feldstein, *A New Era of Social Security*, 130 PUB. INT. 102 (1998) (hereinafter *A New Era*).
  40. Some proponents of the status quo support their position on the basis of a recent report of the Boskin Commission that the current consumer price index (CPI) used to adjust Social Security benefits to account for the effects of inflation has been overstating inflation by approximately 1.1 percent for years. Dean Baker, *GETTING PRICES RIGHT: THE DEBATE OVER THE CONSUMER PRICE INDEX* (1998). Were indexing adjusted downward to reflect this error, approximately one-half of the present long-term actuarial deficit could be eliminated. Gramlich, *supra* note 5, at 53; Harold G. Vatter & John F. Walker, *Support for Baby-Boom*

*Retirees—Not to Worry*, 32 J. ECON. ISSUES 79 (1998).

41. Even President Clinton's 1994–1996 Social Security Advisory Council, although strongly in agreement on the necessity for reform, was unable to reach consensus as to the type of reform. Seven of the 13 members of the council advocated at least partial privatization. 1994–1996 ADVISORY COUNCIL ON SOCIAL SECURITY, REPORT VOL. I: FINDINGS AND RECOMMENDATIONS 19–20 (1997) (hereinafter ADVISORY COUNCIL REPORT).
42. *See generally*, Steuerle & Bakija, *supra* note 2; Forman, *supra* note 7; Aaron & Reischauer, *supra* note 3; Wheeler & Kearney, *supra* note 27.
43. Wheeler & Kearney, *supra* note 27, at 16.
44. However, there is still a significant portion of the elderly population at great economic risk. One reform that has been suggested is to change the benefit formula to provide higher rates of return to low-income earners or institutionalize minimum levels of benefit. Steuerle & Bakija, *supra* note 2, at 57.
45. *But see* Hugh Heclo, *A Political Science Perspective on Social Security Reform*, in SOCIAL SECURITY DEBATE, *supra* note 13, at 66, for the proposition that in spite of greatly shaken confidence in the system, people have not responded by accumulating greater personal savings.
46. This approach, called the Maintain Benefits plan, was suggested by a group of advisory council members. Advisory Council Report, *supra* note 41, at 25–27.
47. According to Martin Feldstein of Harvard University, who is on the short list of possible replacements for Alan Greenspan as Federal Reserve chair, the real value to prefunding is that it raises the economic well-being of the population by “forcing” individuals to save during their working years for their retirement. Martin Feldstein, *A New Era of Social Security*, 130 PUB. INT. 102 (1998) (hereinafter *A New Era*).
48. Gramlich, *supra* note 5, at 58.
49. *See supra* notes 13–15 and accompanying text.
50. “The key to the implicit rate of return is that the payroll taxes paid by that next generation of employees will be higher than the taxes retirees had paid when they were working (because the later generation of employees is both more numerous and, on average, has higher average real wages) and, therefore, can finance benefits that are greater than the taxes retirees had paid when they were working.” *A New Era*, *supra* note 39, at 107.
51. In the long run, the “implicit” rate of return should decrease as the number of people working and subject to payroll taxes decreases.
52. Using data from the 68-year period from 1926 to 1994 as a benchmark, Martin Feldstein predicts a 5.5 percent future rate of return adjusted for inflation, almost three times the predicted “implicit” rate of return. *A New Era*, *supra* note 39, at 107.
53. A hike in the payroll tax that affects the baby boom generation, while not as off-limits as reducing the benefits promised to already retired generations, is still a political hot potato.
54. Whereas the predicted surplus in the next decade is \$2.6 trillion, some \$1.8 trillion is from payroll taxes and will find itself in the Social Security trust fund coffers in any case. The debate is over the remaining \$800 billion surplus.
55. This is a multitiered plan that includes a proposal to allocate some portion of the surplus to so-called USAs, or universal savings accounts, which are essentially federal funds that match individual savings. Under President Clinton's plan, those Americans entitled to USAs will be able to make investment choices for these matching funds themselves.
56. Greenspan parts company with the President on the issue of how to invest the Social Security trust fund, i.e., whether to continue investing in government obligations or to switch to private debt and equity instruments. Greenspan argues against investing the Social Security trust fund in private debt and equity instruments because of evidence that public defined benefit plans, such as the current Social Security model, tend to produce lower rates of return than private plans. This outcome is attributed to political pressure to allocate capital to less than its most productive use. Given the sheer size of a prefunded Social Security trust fund, the efficiency of U.S. capital markets could be at risk.
57. More recently, several additional plans for prefunding the Social Security trust fund have been proposed by both the White House and Congress. The President has indicated his approval of the so-

called lockbox proposal that has already passed the House of Representatives. This proposal would guarantee that future surplus from Social Security be deposited in the Social Security trust fund. The president has also proposed that Treasury bonds, presently held by the public, be deposited into the trust fund as they are paid off.

Not everyone is happy with prefunding the trust fund using only past and future Social Security surplus. Although this measure is certainly helpful, many experts, such as Henry Aaron, a senior fellow at the Brookings Institution and an expert on Social Security financing, do not believe it is enough. Aaron and others predict that without either a fairly immediate commitment of general revenue funds to Social Security or an increase in payroll taxes, the solution is only short term.

58. See Jonathan Chait, *Giving Away the Farm*, 31 WASH. MONTHLY 42 (1999). But see, e.g., much commentary that USAs are simply the White House red herring to the tax-cut proposals of the Republicans.
59. As detractors have noted, privatizing is not so much an answer to financing Social Security as it is a change in philosophy.
60. Steuerle & Bakija, *supra* note 2, at 57.

61. The 1994–1996 Social Security Advisory Council, unable to reach a consensus on reform, released a report advancing three different proposals for reform. Two are based on a partially privatized model. The individual account (IA) model recommends a mandatory increase of 1.6 percent in payroll tax to fund the IAs. This plan retains some of the benefit and redistributive aspects of the current system and adds a defined contribution partially privatized component. The personal security account (PSA) model would be funded by the reallocation of 5 percentage points of the employee's share of payroll tax. The proposal contains a minimum benefit for certain workers. See Kathryn L. Moore, *Privatization of Social Security: Misguided Reform*, 71 TEMPLE L. REV. 131, 151–53 (1998).
62. Robert Kuttner, *Surplus Worship*, AM. PROSPECT 6 (1999).
63. See *supra* note 57.
64. Henry Aaron & Robert D. Reischauer, COUNTDOWN TO REFORM: THE GREAT SOCIAL SECURITY DEBATE (1998).
65. Moore, *supra* note 61, at 166.